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August 1, 1997

David S. Guzy, Chief
Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P. O. Box 25165, MS 3101
Denver, Colorado 80225

Dear Mr. Guzy:

The State and Tribal Royalty Audit Committee (STRAC) submits the following comments on the proposed rule of the Minerals Management Service (MMS) on valuation of crude oil produced from federal lands. STRAC is an organization composed of representatives from 11 States and 8 Tribes, all of which are involved in auditing royalty receipts from federal and Indian lands located in their respective jurisdictions.

At the outset, STRAC notes that the following comments apply only to the proposal for valuing crude oil produced from federal lands. STRAC understands that a separate rulemaking will be undertaken for establishing the rules for valuing crude oil produced from Indian lands. While many States advocate the principle that the public trust doctrine applies equally to the administration of federal public lands, it is beyond debate that the Department of the Interior must operate as a fiduciary to protect the interests of Indian Tribes and Allottees.

STRAC's comments are in two parts. Part one addresses various issues arising under MMS' originally proposed rule at 62 Fed. Reg. 3742. The second part addresses MMS' amended proposals at 62 Fed. Reg. 36030.

Part I: MMS Original Proposal

Posted Prices

STRAC commends MMS for reopening the issue of the proper valuation of federal crude oil. Contrary to the suggestions of some commenters, MMS has not acted precipitously in pursuing this rulemaking; it has acted in a careful, open and deliberative manner. MMS acted only after several years of experience under the 1988 regulations, only after multiple requests for information and input from its constituents and only after investigation and consultation with experts in the economics and marketing of crude oil.

Indeed, given the preeminence of posted prices as a value determinant under the 1988 regulations and as the value being reported by lessees for federal royalties, it would have been remiss for MMS to ignore the mounting evidence that posted prices cannot serve as a basis for determining the value of crude oil. Sell-offs by the States of California and Texas, and indeed by the federal government, have yielded substantial bonuses over posted prices. This mirrors the bonuses over postings being paid under arm's length transactions as found in numerous audits of lessees conducted by STRAC auditors in the 1990s. Substantial and consistent discrepancies have existed since 1987 between reported spot and P-Plus market prices and the posted prices east of the Rockies. In California, three separate analyses done for Interior's Task Force demonstrated undervaluation caused by the use of posted prices, all of which were buttressed by evidence that the posting companies would not trade and did not consider their own posted prices to represent the true value of California production. As early as 1993 at least one major company, ARCO, approached several States and private royalty owners to make voluntary settlement payments reflecting a value for the production over posted prices.

In short, industry's own actions and words demonstrate that posted prices can no longer be relied upon for determining value. Under MMS' current regulations, reliance on posted prices, at the very least, impacts the royalties owed on 70 percent of federal oil. Over the last five years, premia in the P-Plus market and WTI and WTS spot markets, adjusted for transportation, have averaged well over $1.00 per barrel, at times reaching a high of $4.00 per barrel. It is safe to say that use of posted prices for valuing federal production is easily costing the public tens of millions of dollars. There is simply no sound reason for MMS to continue to recognize posted prices in the determination of royalty value.

Alternative Valuation Methodologies

As MMS is by now well aware, there is some diversity of opinion among the STRAC jurisdictions as to what methodologies to employ in the determination of crude oil value. STRAC's review of the comments submitted by various States indicates that there is support for use of an "index" or "marker" price for valuation of crude oil transferred under non-arm's length arrangements, although there is some disagreement east of the Rockies as to which "index" would be the most convenient.

There is a somewhat greater degree of disagreement on the scope and use of the arm's length gross proceeds method, although it is significant to note that in the main that debate has focused on how best to preserve the gross proceeds valuation method for use by independent producers. As a representative organization, STRAC of course respects the views of all of its member jurisdictions and believes each has brought forward important perspectives that will aid MMS in crafting an appropriate rule.

While their views on acceptable methodologies might vary, all STRAC jurisdictions acknowledge that it is the Secretary's duty to collect royalty on the basis of the true "value" of the production. STRAC as an organization is committed to enforcement of this principle. As auditors, STRAC also has concerns over the workability of various methodologies. Thus, to the extent that there does exist more than one rationally based methodology that MMS could employ to determine true value, STRAC suggests that MMS also evaluate the extent to which each methodology maximizes independence, verifiability and efficiency.

- Independence. The ultimate goal of auditors and administrators should be to provide their constituents adequate assurance that full royalties are being collected. The employment of objective criteria to determine and/or cross check royalty payments meets this goal. Criteria and information that is free from manipulative influence or control of regulated entities should be preferred. To the extent possible, the criteria should reduce the opportunity for gaming.

- Verifiability. Again to the extent practicable, a methodology that can be applied through use of reliable, independent data that is readily available or that is more easily (and more amicably) accessed or compiled should be preferred. Methodologies that are dependent on tracing particular lease production through multiple transactions or on surveys of difficult to obtain or unaudited third party sales should be the exception not the rule.

- Efficiency. MMS monitors royalty compliance on over 25,000 leases. It currently is heavily dependent on orders to perform as an enforcement tool and on projections of underpayment. Ideally, lessees should be able to determine in advance how MMS expects them to compute their royalties and should have access to identifiable information they need for that calculation. And, MMS should have a system that enables it to assure compliance on a large percentage of the federal lease universe. These considerations counsel against a multi-tiered or option laden valuation system and for reducing reliance on transaction specific or subjective standards (e.g., comparable sales, significant quantities).

Applying these parameters, it is the consensus of STRAC that MMS' abandonment of the comparable sales benchmarks is correct.[1] Industry itself has conceded that it cannot apply the comparable sales methodology on a timely, current basis.

Those who have suggested that MMS is in a better position to publish "comparable sales" information for use by lessees in calculating royalties do not have a sound understanding of MMS' automated systems. The first problem with this suggestion is that, because of the nature of the information reported to MMS, any "comparable sales" computation will result in a "value" that reflects posted prices. It is STRAC's experience that the almost universal practice of industry is to report posted price as the basis of royalties. This is particularly true with regard to prices reported by major companies and integrated independents (those with marketing arms and/or refineries), who report on the vast majority of federal production. Thus a comparable sales methodology based on information reported to MMS will not represent a move away from valuation based on posted prices, which is the aim of this rulemaking.

The second problem with this suggestion is the fact that the data entered into MMS' system is unaudited. It is hard to understand how the public interest would be served by permitting lessees operating under non-arm's length (NAL) transactions (70 percent of federal production) to base their royalties on unaudited and potentially misreported data. Those reporting arm's length information to MMS will eventually be subject to audit, adjustments for any royalty underpayments and interest. Based on STRAC's familiarity with the MMS automated systems, it is difficult to understand why NAL lessees would want to expose themselves to the audit and interest risk of reliance on data reported by AL lessees.

The third problem with industry's "comparable sales" approach is that MMS cannot sort the information reported to it by field or area. Indeed, just recently STRAC learned that the Interior Department still has no uniform method for field and area designation -- the closest method MMS has, under an as yet untested system, is to group leases by county. Unfortunately, oil is not known for migrating in a manner that respects jurisdictional lines. And, of course, there are no jurisdictional subdivisions relating to the OCS. Similarly, MMS cannot through automation determine whether any particular sale involves "significant quantities" -- a problem that becomes insurmountable in areas of checkerboard ownership. Then, of course, there are the comparability factors (e.g., volumes, quality, contract terms). And, finally, of course, MMS system only captures information reported on federal leases; it thus cannot generate the full picture on how oil is being traded in a particular field or area. MMS' system was not designed to address these issues, there are serious questions whether it ever could, and even if it could, at most what could be generated are unaudited estimates, subject to audit and interest accrual.

[1] It should be noted that the Wyoming jurisdiction supports a position different from STRAC's consensus on comparable sales. Wyoming finds comparable sales drawn from MMS' system, with refinements to that system, to be a workable methodology.

Finally, even assuming perfect reporting by all arm's length lessees and a computer program capable of sorting on the basis of the undefined terms, unavailable data and subjective comparability factors, it is doubtful that MMS could publish on a nationwide basis the information needed by NAL lessees in order to pay royalties on a monthly basis. Exceptions processing alone, which provides a minimum of the internal consistency of reported information, would delay any publication of comparable sales information.

Audit, of course, is a better tool for deriving a comparable sales "value."[2] But, it is also an after-the-fact tool; meaning that the Secretary could not check reported and paid values until several years after royalty payments are actually due. Again, this exposes industry to substantial interest liability and uncertainty.

Audit of comparable sales is also, unfortunately, an imperfect tool, especially under a payor based audit system and in areas of checkerboard land ownership. MMS would need to audit, at the least, all AL federal payors in a field or area before NAL royalties in that area could be finally determined. Contentious issues of document access are raised, as are issues about maintaining the confidentiality of data provided by non-targeted payors or third parties who cooperate with an MMS audit.[3] Problematic issues of timing are involved -- will a subpoena to a non-targeted payor or third party for comparable sales data serve to toll the statute of limitations on the payments made by a targeted payor? Case by case adjudication on issues of "significant quantities," "field or area," and the comparability factors will surely ensue. The compliance and enforcement costs of considered application of a comparable sales methodology alone support MMS' abandonment of these benchmarks.

Industry has long asserted that its main interest is certainty -- a system under which it knows, in advance, how to calculate royalties. A comparable sales methodology does not and cannot serve that interest.

Exchange Agreements

STRAC supports MMS' proposal to value royalty transferred under exchange agreements under the non-arm's-length rules.

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[2] Use of the term "value" here should not be read as a concession by STRAC that the comparable sales approach will yield a true value for federal production. There are some STRAC jurisdictions that vigorously oppose this concept. For example, suppose a field that is controlled by a single pipeline company, which produces, transfers its own production internally and is the sole purchaser in the field. Reasonable people can disagree on the relative fairness of accepting the arm's length gross proceeds received by a single independent from the pipeline in that same field and, at the same time, be in accord that the price received under the AL contract should not be used to value the NAL production.

[3] STRAC notes in this regard that there has been industry opposition to MMS' proposal to release proprietary information to companies appealing a royalty underpayment determination.

STRAC has no quarrel with industry's assertion concerning the utility of exchange agreements in the marketing of oil production. Yet the utility of exchange agreements to industry has very little bearing on the issue confronting MMS, which is what impact such agreements have on valuing federal production.

The impact of exchange agreements appears to be two-fold. First, there is some reason to suspect that the use of exchange agreements is, at the least, one of the vehicles that assists the depression of posted prices. A study conducted for the American Petroleum Institute concluded that:

> Exchanges maximize the advantages which size and integration accord the majors and minimize potential competitive influences on the structure of prices. Thus they must help to preserve the rigidity and decrease the significance of the posted price.

M.G. de Chazeau, A.E. Kahn, Integration and Competition in the Petroleum Industry, p. 186.

Of more immediate concern in terms of MMS' specific proposal on exchange agreements is the unreliability of the prices stated under those agreements as a basis for determining value. The fact is that these trades are not conducted on a price basis. For integrated companies, the trade is conducted on the basis of the internal value of the crude oil to its refinery. These trades "are driven by economics basically independent of the crude oil market." Expert Report of Mark L. Venrick (Exxon) in Exxon Corp. et al v. Commissioner, Nos. 18618-89, 24855-89, 18432-90 (February 7, 1991). It must be presumed that non-integrated producers, to the extent they enter into exchanges, are motivated by a similar profit motive and view the exchange as a means of obtaining more value for their lease production than would an outright sale at the lease. As explained by an Exxon expert, prices stated in these agreements are simply not meaningful:

> Legally, exchanges can be treated as a single transaction, subject to a single legal document, or as two "matching" transactions, a sale and a purchase, each subject to a separate document. In the latter case, known as a purchase/sale agreement, each contract stands as an independent purchase and as a separate sale of a particular volume of crude oil, with a price specified for each crude oil. ...[T]he prices specified can be completely arbitrary, as long as the difference between the two prices accurately reflects the bargain struck by the parties.

Id. at pp. 2-3 (Emphasis supplied). This statement mirrors the information STRAC understands was provided MMS by the economists and marketers it consulted. Of equally relevant note is the fact that the values being ascribed to production transferred under exchange agreements are not related to prices in the lease or field market.

In short, when a commodity is not being traded on a price basis, there is no sound reason why third parties, such as the federal government, should be bound to the price stated in the trade. Accordingly STRAC supports MMS' proposal to look beyond exchange agreements for purposes of valuation.

Duty to Market/Marketable Condition

STRAC supports MMS' continued recognition of the lessee's duty to market in these regulations. STRAC also supports MMS' retention of the marketable condition rule.

The extent to which these principles have been the subject of attack by industry in the context of this rulemaking is surprising. While industry's primary focus of objection appears to be directed at the relation between these principles and deductibility of costs, STRAC is concerned that this rhetoric will serve to dilute application of these principles more generally. As MMS is aware, it has been STRAC's consistent and long held position that deductible costs should be confined to those reasonable costs that actually and demonstrably enhance the value of a marketable product. It is also STRAC's view that the protection that the duty to market provides against improvident or conflicted business actions of a lessee is an especially important safeguard under any program that bases royalty on proceeds under a particular contract.

It is hardly arbitrary and capricious for MMS to continue to apply a long standing policy; nor (even to the extent that MMS' proposal can be viewed as "new") to recognize through regulation the implied obligation of every lessee. In addition, given the flexibility of the statute and federal leases and the growing body of case law supporting it, requiring the lessee to assume the costs of its duty to market cannot be viewed as an impermissible or unreasonable interpretation or policy choice.

MMS has not proposed a laundry list of those costs that fall within the marketable condition/duty to market rule. Yet, STRAC understands industry to argue that MMS has implicitly determined the scope of non-deductible costs by limiting the acceptable deductions from an index-based value to location and quality differentials. Industry then assumes that this results from MMS' duty to market proposal. STRAC has two brief comments concerning this very imaginative argument.

First, STRAC had never understood MMS' proposal with regard to location differentials and gravity differentials to stem, in whole or in part, from the duty to market principle. Rather, the location and gravity adjustments to a marker or index price are based on industry's own practice of applying those differentials in determining the value of particular crude oils. While reasonable people might disagree on how MMS has proposed to calculate differentials, it is difficult to find any justification for MMS to recognize differentials beyond those recognized and applied by industry itself. MMS' approach is also consistent with that applied to those lessees calculating oil royalties under a gross proceeds methodology, who are entitled only to a transportation allowance.

Second, industry's argument, at least in part, is that lessees should be able to transform nondeductible marketing costs into deductible costs if a different entity, either affiliated or not, performs the duty to market. STRAC's position is that the duty to market does indeed preclude such a result. E.g., Wegman v. Central Transmission, Inc., 499 So. 2d 436 (La. App. 1986), writ denied, 503 So. 2d 478 (La. 1987); Texas Oil & Gas Corp. v. Hagen, 683 S.W. 2d 24 (Tex. App. 1984). Lessees should not be permitted to spin off their royalty obligations in a manner that creates costs that would otherwise not be chargeable to the lessor's royalty interest.

STRAC also understands that some independents are concerned that recognition of a duty to market will force them into use of index-based pricing. We believe that MMS' specific recognition of a gross proceeds methodology obviates this concern as a practical matter.

FERC Tariffs

STRAC supports MMS proposal to discontinue the acceptance of tariffs in the determination of transportation allowances in non-arm's length transactions. STRAC, as MMS knows, has long urged MMS to reject use of these tariffs. Unfortunately, filed tariffs are not the subject of uniform or regular review by FERC; at the very least it is incumbent on MMS to take a hard look at whether the costs rolled into a tariff are truly royalty bearing, reasonable or even reflective of actual costs. STRAC is aware of several situations of exorbitant profit taking in transportation through tariffs.

Royalty In Kind

STRAC has long expressed its concern about the manner in which MMS establishes the "price" at which it sells royalty oil taken in kind. MMS has in essence delegated the determination of price to the lessee. In doing so, it has not only received less than it could for the federal production (lessees typically reported posted price), but also unnecessarily complicated matters of ultimate liability for undervaluation. It is also STRAC's sense that the MMS RIK program has become a vehicle for refiners to obtain cheap oil rather than needed oil, as was intended. Without expressing any views on whether the RIK program should be expanded or ended, STRAC does support a change that would assure that the federal government receives a reasonable market value for the production taken in kind and generally supports MMS move in that direction under its proposed rules.

Part II: MMS' Amended Proposal

In its originally proposed rules, MMS excluded from the scope of gross proceeds calls and all exchange agreements. MMS also proposed that lessees could not use gross proceeds if they had purchased crude oil from their buyer within the last two years. Generally, STRAC supported these exclusions from gross proceeds. Our support stems from the fact that in each of these three situations, the lessee and its buyer may be influenced by factors going beyond the four corners of the sale of crude oil from federal lands. The difficulties associated with unraveling and quantifying this "other consideration", we believe, justifies excluding such transactions from the gross proceeds rule.

STRAC also notes that there is a factual basis for MMS' concern that these particular types of transactions can affect the full collection of royalties. We have already discussed the problems associated with exchanges. STRAC auditors have also detected situations where a call was granted in conjunction with a discount on the purchase price of a property. And situations involving multiple trades, especially (but not exclusively) trades of different quality crude oils or time trades, will obviously trigger a need for balancing. It is our understanding that MMS' independent investigation and consultation with marketers and other consultants confirmed that these situations raise legitimate royalty and compliance concerns.

Compliance, administrative efficiency, certainty and assurance of full collection all support the imposition of bright line rules. Case by case consideration of transactions between a lessee and others is a costly exercise that yields uncertain results. It also makes difficult the use of compliance tools such as projections and orders to perform.

At the same time, STRAC recognizes that bright line rules can capture situations that fall outside the underlying purpose of the rules. And, it is our understanding that it was IPAA's highlighting of such situations that led to MMS' amended proposal. STRAC supports the general direction of MMS' amended proposal. However, STRAC also believes that the effect of MMS' proposed regulatory language sweeps too far, and thus recommends the following modifications.

Calls. STRAC supports MMS' proposal to modify the call provision to exclude unexercised calls. We believe that this proposal is logically consistent with the gross proceeds rule. STRAC has concerns, however, with MMS' proposal to also exclude contracts with Most Favored Nations (MFN) or other escalation clauses. Our concern is stems from several areas.

First, STRAC does not agree that the simple existence of an escalation clause suggests that the actual sale of the crude oil was not influenced by the call provision. There may be many reasons why a lessee chooses not to enforce or cannot enforce an escalation provision. Industry itself has admitted, for example, that it cannot undertake a comparable sales analysis, which would be necessary under an MFN that entitles a lessee to the highest field price. Thus, STRAC recommends that MMS modify this proposal to apply only to enforced escalation clauses.

Second, STRAC has some concerns about the type of escalation clauses MMS will accept. Some types of MFNs could be triggered by non-arm's length prices -- for example, the call holder purchases crude oil from an affiliate at a price higher than that under its call. Accordingly, STRAC recommends that MMS modify its proposal to apply only to price escalation provisions that are triggered by outright sales or bids of third parties or values that are acceptable under MMS rules.

Finally, STRAC notes that the phrase "or a similar clause in which the price is based on what other parties are willing to competitively bid to purchase the production" appears to be a definition of what has been more conveniently called a "Bona Fide Offer Provision." We believe that greater certainty would be achieved by use of this term.

Overall Balancing. STRAC agrees with MMS that certain purchases of oil by a lessee should not preclude it from use of the gross proceeds methodology. As explained by the preamble, MMS' intent is to exclude purchases made to meet production shortfalls and for lease operation.

While STRAC agrees that purchases of this nature should not preclude a lessee from calculating royalties on a gross proceeds basis, STRAC has serious concerns with MMS' proposed regulatory language.

First, it is not our understanding that balancing is always conducted on a strict volume basis as suggested by MMS' proposed regulatory language. For example, where different quality crudes are traded by the parties, the issue of relative value will become an element in any balancing arrangement.[4]

More importantly, however, MMS' language will cause difficult compliance problems. In essence, the burden will be placed on MMS to determine whether an overall balance is maintained by the lessee and another party. It is STRAC's understanding that these types of arrangements are often informal in nature, which will require auditors to trace and compare all of the transactions between the parties to determine if a relationship exists and may indeed involve accessing documents or even testimony from company employees, such as marketers, that currently is not part of the normal audit routine.

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[4] We are also concerned with MMS' emphasis in its preamble on "discounted" prices. STRAC does not deny that "discounting" can occur. However, it was STRAC's understanding that the more fundamental problem with exchanges and overall balance situations is that they represent trades that are simply not conducted on a price or pure price basis. In other words, the price stated in the contract is of little relevance to determining the value of the production.

Second, STRAC is concerned about MMS' proposal that a contract price will be acceptable, even in the face of an overall balance situation, where it represents "market value in the field or area." Since the very purpose of this rulemaking is to set out the methodologies to determine "market value in the field or area," the inclusion of this language can only create confusion and engender litigation. STRAC is concerned that given the placement of this language (within a rule that is intended to narrow the situations that would require an independent to use an indexed based value) MMS has opened the door to use of a comparable sales methodology. For the reasons stated earlier, STRAC opposes use of such a methodology.

For the foregoing reasons, STRAC recommends that MMS modify the regulatory language on overall balance situations to provide:

1. That indexed based value must be used where the arm's length contract is subject to an informal or formal overall balance arrangement maintained between the buyer and seller.

2. That there is a rebuttable presumption that an overall balance arrangement exists where the lessee has purchased oil (or, as advocated by the State of Louisiana, NGLs, gas, and finished or unfinished products) from its buyer within the last two years.

3. That the rule does not apply for oil purchased to meet production shortfalls or for lease operations.

Exchange Agreements

As discussed earlier, STRAC supports the exclusion of exchange agreements from the gross proceeds rule. STRAC, however, reluctantly supports MMS' amended proposal on the understanding that (1) it does not propose valuation on the basis of the price stated in the exchange; and (2) it does not propose an alternative valuation based on a comparable sales methodology. Rather, MMS' proposal will apply only in situations of a single exchange by a lessee where all of the production received under that exchange is actually sold (and not further exchanged or transferred internally or by sale to an affiliated entity) pursuant to an arm's length contract. While STRAC agrees that any exception to the more general exclusion of exchange agreements from the gross proceeds rule must remain narrow, many in STRAC believe that MMS might want to consider a slight expansion of its proposed exception to apply to a single exchange by a lessee or its affiliate where the all of the production received under that exchange is sold arm's length. It is the consensus of STRAC that this would be analogous to MMS' proposal on affiliate sales' gross proceeds, although STRAC recognizes that it may involve a more complicated inquiry if an affiliate exchanges commingled production. The STRAC consensus also believes that this is consistent with MMS' concerns about the treatment of independents; concerns that are reflected in the amended proposals. Because of STRAC's opposition to the comparable sales methodology,[5] however, it does believe that any further move by MMS towards the concerns of independents should be accompanied by removing from the amended proposal any suggestions, implicit or otherwise, that comparable sales is an acceptable methodology.

STRAC would note that the MMS' amended proposal on exchanges will engender certain compliance problems that result from the necessity of tracing the exchange. STRAC also has some concerns that this provision will invite gaming. We would remind MMS of the situations recently brought to its attention during a STRAC meeting where a nominal "arm's length" transfer of production to an unaffiliated party was made, with the oil then transferred back to the lessee or its affiliate. While STRAC has considerable concerns about its workability, we note that MMS' strengthened definition of "sales" theoretically would serve as a safeguard against such situations.

Finally, STRAC urges MMS to assure that its rules adequately set out its (and its delegates) authority to access all of the information necessary to assure full compliance with these rules, including but not limited to information that will enable auditors to determine whether a true sale has occurred.

Sincerely,

Wanda Fleming

Wanda Fleming
Chair

cc: STRAC Membership

[5]With the exception of the State of Wyoming